IFRS

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IAS 16 *Property, Plant and Equipment***
Paper topic	Accounting for proceeds and cost of testing PPE: Summary of outreach results

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Introduction

1. The purpose of this paper is to provide an overview of the additional outreach conducted in relation to the issue of accounting for proceeds and cost of testing Property, Plant and Equipment (PPE).

   In November 2014, the Interpretations Committee decided that the following issues to be considered:

   (a) when the asset is available for use;

   (b) what costs qualify as costs of testing, while bringing the asset to that location and condition;

   (c) how to treat the proceeds in excess of the costs of testing;

   (d) how to account for other proceeds received on other activities (that are not testing) that are necessary to bring the asset to that location and condition;

   (e) disclosure of proceeds deducted from assets; and

   (f) applicability of IFRS 15 to the proceeds received.

Summary of outreach

2. Four stakeholders have been contacted for outreach to supplement the outreach conducted before the November 2014 Interpretations Committee meeting: a preparer in the extractive industry; a preparer in the electricity generating industry, an industry group of oil and gas producers and IFRS Discussion Group of Canadian accounting standard setter.

Outreach for preparers in the extractive industry and power generating industry

3. Preparers in the extractive (mining) industry and power generating industry have provided us with their comments on each issue stated in paragraph 1 of this agenda paper. The results of this feedback are set out in paragraph 4 to 34.

General questions—the circumstances that lead to pre-commissioning revenue

(Feedback from mining entity)

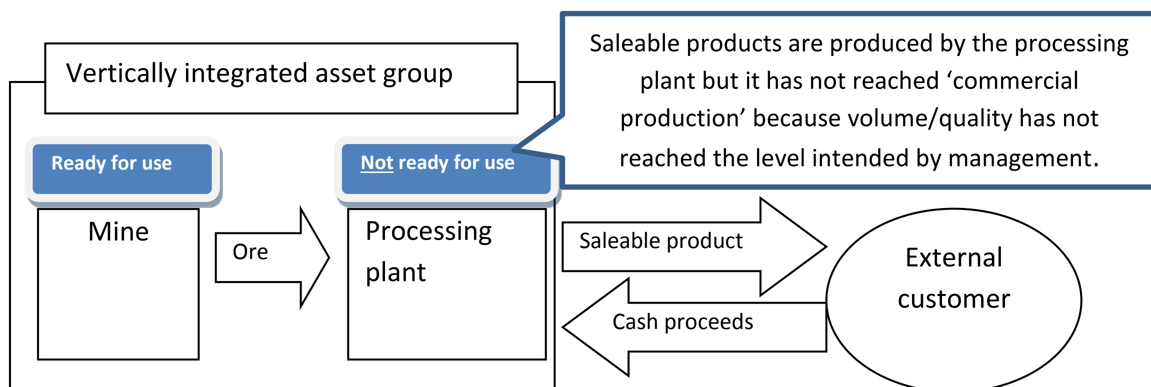
4. Pre-commissioning revenue arises when an operation is capable of producing saleable output but is not yet capable of ‘commercial production’. This is not uncommon, because of the scale and complexity of some mining projects, which can take many months, or in some cases, years, to establish a stable operating platform capable of production at commercial volumes.

5. A key factor in the development of a mine is the development of the associated processing plant. Typically, the mineral produced from the mine will be processed before being sold. It is common that the first ore produced by the mine will be used to test the processing plant. Consequently, the situation may arise in which the development of a mine has reached the stage where it is capable of operating as intended, but the processing plant is still undergoing testing and has not yet reached the condition necessary for it to be capable of operating in the manner intended by management.

6. Pre-commissioning revenue can be recognised in both the development phase and the production phase of a mine. During the development phase, saleable ore is

extracted in conjunction with the removal of overburden or waste material for the purpose of obtaining access to an ore body. Even during the production phase of a mine, pre-commissioning revenue can be recognised when the accompanying processing plant is not yet capable of operating in the manner intended by management. The respondent described to us that it does not sell product directly from the mines and that all extracted product is processed before being sold. For coal, the processing is washing the coal and so the coal processing plant needs a relatively short pre-commissioning period to be ready for its intended use. In contrast, a smelting plant for metal ore would take a longer period to complete the testing phase and to bring the processing plant to the condition necessary for it to be capable of operating in the manner intended by management. We understand that 'operating in the manner intended by management' is assessed in terms of the plant being capable of meeting certain quality standards and capable of handling minimum throughput capacities.

7. The ore extracted during the development phase of the mine may not be material. A significant portion of pre-commissioning revenue may instead be recognised in relation to the period spent completing the construction of the processing plant, while the mine is already ready for its intended use. These proceeds from selling the saleable product may be proceeds from testing the processing plant rather than the proceeds from testing the mine.



8. We understand that a key issue for the mining industry is the development of the processing plant, which may take significant time. Pre-commissioning revenue can be material before the processing plant becomes ready for its intended use. In cases where the processing plant fails to reach the throughput capacities intended

by management, the failed processing plant may be scrapped and a new one constructed. Consequently considerable time (eg years) can pass before the processing plant is finally considered to be capable of operating in the manner intended by management. During this time, 'pre-commissioning revenue' generated can be material.

(Feedback from electricity generating entity)

9. In order for a power plant to be connected to the electricity grid and deliver electricity, it is necessary to obtain appropriate authorisation. The purpose of testing is to see whether electricity is delivered with the efficiency that was expected. The actual construction of a power generating plant is usually outsourced to external contractors.

10. Testing has two purposes. Firstly, the entity needs to make sure that the external contractors have achieved the agreed features. Secondly, from the legal perspective, it is necessary for the entity to test the power plant to demonstrate that it operates within the parameters required by the government and to receive the necessary authorisation to operate. In some countries, this testing is necessary to connect the power generating plant to the national grid.

General questions—how material is pre-commissioning revenue

(Feedback from mining entity)

11. Pre-commissioning revenues can be material in situations in which there is an extended ramp-up. This can also be sensitive to changes in commodity prices.

(Feedback from electricity generating entity)

12. The amounts at stake are not material because of the short pre-commissioning period.

General questions—the length of any pre-commissioning period

(Feedback from mining entity)

13. The length of the period between the first production of saleable product and commercial production is dependent on the complexity of both the mine and the

processing plant and is a matter of significant judgement. It could range from months to years.

(Feedback from electricity generating entity)

14. It depends on the type of power-generating plant. The testing process ranges from a few weeks (for a conventional power generating plant; for example, coal, gas) to a few months (nuclear). A nuclear power plant has a longer testing process because many different authorisations need to be obtained.

(a) assessing when the asset is available for use

(Feedback from mining entity)

15. An asset is considered to be available for use at the point when it reaches ‘commercial production’. This determination is based on a range of criteria, including:

    (i) As a general rule, commercial production may be deemed to have been achieved when the mine assets are operating at a predetermined percentage (for example, 80 per cent) of nameplate production capacity/throughput. However, this 80 per cent is not a hard and fast rule. For example, if the mine is operating at a 60 per cent level and operating at that level is expected to continue, 60 per cent may become the revised level for ‘operation as intended by management’. The way in which the company reconciles this approach with paragraph 20(a) of IAS 16 is that the company predetermines the production level intended by management. The company considers that the asset is not operating as intended by management if the production level is less than this predetermined capacity.

    (ii) Mineral recoveries at or near expected levels and the ability to produce saleable product (eg, the ability to produce within intended specifications).

    (iii) The achievement of continuous and stable production or other output (eg plant throughput).

(iv) The completion of major capital expenditures to bring the mine to the condition necessary for it to be capable of operating in the manner intended by management.

(v) Completion of a reasonable period of testing of the mine plant and equipment.

(vi) Transfer of personnel from internal development groups or external contractors to operational roles.

(vii) Ability to sustain ongoing production (ie, the ability to continue to produce at a steady or increasing level).

(viii) For each of these criteria, the targets (ie percentages, levels of recovery etc) to be achieved are determined for each project individually.

(ix) Whether commercial production was achieved or not is reviewed regularly by the audit committee and is not a mere matter of management judgement.

(Feedback from electricity generating entity)

16. The practice is that the power plant is considered to be capable of operating in the manner intended by management at the Commercial Operation Date (COD). This is the date when (a) risks are transferred from the constructor to the entity and (b) when the performance is tested and approved. At that time, the entity has the ability to use the asset in accordance with its strategy. This is called the ‘provisional acceptance’. Final acceptance is issued after 2-3 years but the final acceptance is not used as a milestone to determine whether the asset is capable of operating in the manner intended by management.

(b) Determining what costs qualify as costs of testing while bringing the asset to that location and condition

(Feedback from mining entity)

17. The respondent does not separately identify ‘costs of testing’ as a category of costs. During the pre-commissioning period of a mining operation, a range of activities are undertaken that are directly attributable to bringing the asset into commercial production. These activities include those associated with the

physical construction of the operation, the ‘ramp-up’ of operating activities at non-commercial levels (which is necessary to evaluate the ability of the operation to operate as intended), and activities such as sampling and analysis. The respondent’s policy is to capitalise the cost of all such activities before an asset is in commercial production, and to offset the proceeds from sales of production during this period against the carrying amount of PPE.

(Feedback from electricity generating entity)

18. No specific process is identified as a ‘testing phase’ and testing cost is not specifically calculated.

19. The most significant costs related to testing would be fuel, emission rights costs (if any), and fees for connection to the grid.

(c) How to treat the proceeds in excess of the costs of testing

(Feedback from mining entity)

20. To the extent that proceeds are generated from activities that are directly attributable to bringing an asset to the condition necessary for it to be capable of operating as intended, the respondent offsets the proceeds against the cost of constructing the asset.

(Feedback from electricity generating entity)

21. The whole of the proceeds are deducted from the carrying amount of the PPE.

(d) How to account for other proceeds received on other activities (that are not testing) that are necessary to bring the asset to that location and condition

(Feedback from mining entity)

22. To the extent that proceeds are generated from activities that are directly attributable to bringing an asset to the condition necessary for it to be capable of operating in the manner intended by management, the respondent offsets the proceeds against the cost of constructing the asset.

(Feedback from electricity generating entity)

23. Other proceeds are linked to government grants, investment deduction or liquidated damages (LD). These are deducted from the carrying amount of PPE (for LDs, only those related to the efficiency and performance of the CAPEX will be deducted from the net carrying amount of PPE ; LDs linked to performance delay will be taken in P&L when revenue recognition criteria are met).

(e) Disclosure of proceeds deducted from assets

(Feedback from mining entity)

24. There are examples of some entities in the sector having negative CAPEX because net operating cash inflows deducted from assets exceeded capital expenditure. Typically, these entities disclose the amount of net operating cash inflows that was deducted from CAPEX.

(Feedback from electricity generating entity)

25. No disclosure has been made for proceeds deducted from assets, because the amounts of proceeds are not material with regard to the cost of CAPEX.

(f) Applicability of IFRS 15 to the proceeds received, compared with deducting the proceeds from the cost of the asset

(Feedback from mining entity)

26. The respondent has not analysed whether IFRS 15 *Revenue from Contracts with Customers* would change its practice. The respondent's preliminary view, however, is that IFRS 15 is concerned with the recognition and measurement of contract assets or liabilities under contracts with customers and that the allocation of the credit to the income statement or balance sheet would continue to be dictated by other Standards (eg, IAS 16). This is similar to the current situation, by which proceeds received in the commissioning period of a mine are recognised and measured in accordance with IAS 18 *Revenue* but are credited against PPE where they are attributable to making the asset available for use.

(Feedback from electricity generating entity)

27. The respondent has not analysed whether IFRS 15 would change its practice.

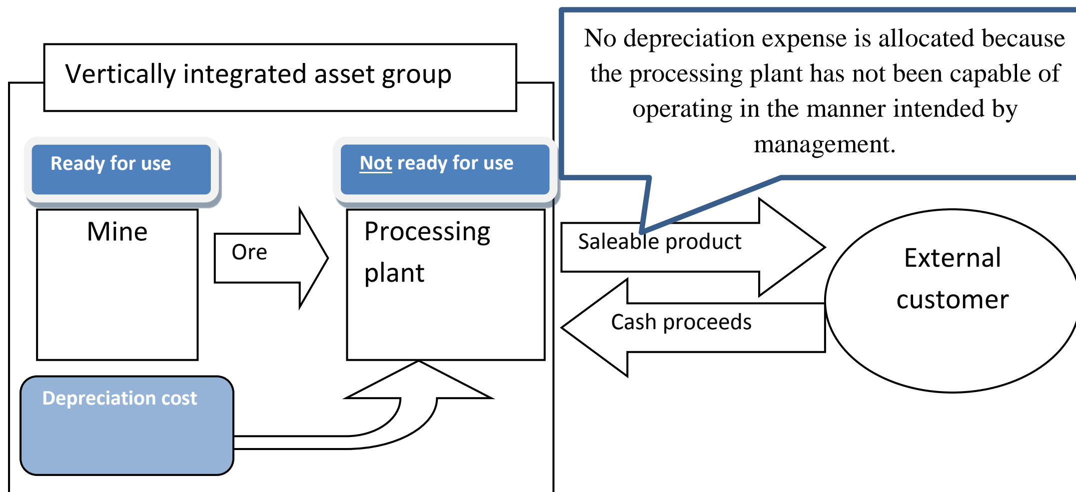
Additional questions—component accounting

(Feedback from mining entity)

28. In practice, the respondent considers a key judgement to be the identification of an appropriate unit of account for this assessment, because it is rarely practical to assess separately each individual component of PPE. Consequently, the decision to cease capitalisation of costs and income is likely to be made at the level of the new operation as a whole, or at the level of material, identifiable components (for example the mine, processing plant, infrastructure) depending on the nature of the assets involved.

29. In the case of vertical integration, a mine could have already reached the point of being ready for its intended use when the processing plant was not yet ready for its intended use. In such a case, the company allocates the depreciation cost of the mine to the cost of the processing plant for the following reason.

30. If the respondent built a processing plant without a mine, the respondent would need to purchase raw material (ore) in order to test the processing plant, as a testing cost. In the respondent’s case, the respondent has a mine and produces the raw material. Accordingly, the respondent does not need to purchase raw material in order to test the processing facility. However, the respondent does not think that the fact that the respondent has a mine should change the accounting. It therefore makes sense to allocate the depreciation cost of the mine to the cost of the processing plant during the testing of the processing plant. When the respondent allocates the depreciation cost of the mine to the processing plant, the remaining depreciation cost becomes lower. If the respondent recognises revenue for saleable product in the income statement before commercial production has begun, the margin becomes higher, because of the lower depreciation costs. Because the respondent deducts pre-commissioning revenue from the cost of the processing plant and capitalises the depreciation cost of the mine to the processing plant, the respondent avoids this problem.



31. As a result, a related issue arises in relation to inventory that was produced during the period *before* the processing plant becomes available for use (commercial production period commences) but that inventory is sold *after* the commercial production period commences. Because this inventory is produced during the period *before* commercial production commences, no depreciation expense would be allocated to the inventory. The question raised therefore is 'should the revenue from such inventory sold *after* the commercial production period commences be deducted from the asset or be recognised in the income statement?' The respondent thinks that there is diversity in practice on this point.

(Feedback from electricity generating entity)

32. The unit of account is a key issue. For instance, you may have one Projected Commercial Operation Date (PCOD) in relation to the construction of four different units. If the units are operating independently, capitalisation (for that unit) will stop and depreciation will begin on a unit-by-unit basis. A more difficult situation relates to when a combined cycled gas-fired power plant (CCGT) can first be operated in open cycle (independently) and afterwards in a combined cycle. In this circumstance:

    (i) when the open cycle is capable of operating in the manner intended by management, part of the CAPEX (the CAPEX needed to operate the open cycle) is depreciated while revenue is recognised in income statement; and

(ii) The remaining portion of the CAPEX is subject to further capitalisation until the plant can be operated in a combined cycle.

Additional questions—diversity in practice in the industry

(Feedback from mining entity)

33. Although many companies in the industry deduct the pre-commissioning revenue from the cost of the asset, there are some that seem to recognise pre-commissioning revenue and the same amount of cost of goods sold in the income statement, until the processing plant is available for use.

(Feedback from electricity generating entity)

34. The respondent is not aware of any diversity in practice. Once provisional acceptance is issued, capitalisation ceases and revenue and depreciation are recognised on the income statement.

Outreach to an industry group of oil and gas producers

35. An industry group of oil and gas producers commented to us that the issue is considered immaterial to the oil and gas industry and that there is no need for further clarification. (We are planning to conduct further outreach to another oil and gas industry group and the result of outreach will be communicated orally during the January 2015 Interpretations Committee meeting.)

Outreach to IFRS Discussion Group of Canadian accounting standard setter

36. Canadian Accounting Standards Board (AcSB) staff shared us the results of the discussions at their IFRS Discussion Group (the Discussion Group) that talks about issues in implementing IFRS. The Discussion Group discussed that the judgements surrounding '(a.) when the asset is available for use' (capable of operating in the manner intended by management) has been a significant issue across various industries and is considered to be causing diversity in practice.

37. The Discussion Group noted that paragraph 20 of IAS 16 provides guidance on when capitalisation ceases and paragraph 55 of IAS 16 provides guidance on when depreciation commences. The issue is what is meant by the phrase 'to be capable of operating in the manner intended by management' within the context of ceasing capitalisation and commencing depreciation.

38. The Discussion Group considered the following three views on the issue:

    (a) View A—management may use a predetermined operating level as a criterion to establish when to cease capitalising costs;

    (b) View B—capitalisation of costs ceases when the asset can create the output that it was designed to produce on a regular basis, even if this is not necessarily at the levels originally planned by management; and

    (c) View C—a policy choice is available.

39. Conceptually there was support for View B, because the approach in View A is subjective and involves a considerable amount of judgement. The Discussion Group members noted that it would be difficult to achieve consistency and comparability among entities if management sets a predetermined threshold for ceasing capitalisation based on their own expectation of how the asset will operate.

40. A few Discussion Group members also noted that consideration should be given to whether certain components of the asset are already in the location and condition necessary for the components to be capable of operating in the manner intended by management.

41. The Discussion Group thinks that adding clarifying guidance about when an asset is available for use (ie, when it is in the location and condition necessary for it to be capable of operating in the manner intended by management) would be beneficial for achieving consistent application.

42. The submitted summary of the Discussion Group's discussion is reproduced in Appendix A.

Appendix A—IFRS Discussion Group[1]

The staff of the Canadian Accounting Standards Board (AcSB) shared with the IFRS Interpretations Committee staff an IFRS implementation issue that was discussed by the AcSB's IFRS Discussion Group[2] in December 2014. The implementation issue discussed relates to the issue "Accounting for Net Proceeds and Costs of Testing for Property, Plant and Equipment" currently being considered by the IFRS Interpretations Committee. This issue relates to determining when an asset is available for use, in the context of applying the phrase "to be capable of operating in the manner intended by management" (paragraph 16 of IAS 16).

The summary below is based on the Group's discussion available on the IFRS Discussion Group's website[3].

IAS 16: Capitalization of Costs

IAS 16 *Property, Plant and Equipment* requires qualifying assets to be initially recognized at cost. Some assets are acquired or constructed over time. Recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Depreciation commences at the same point in time.

Paragraph 16 of IAS 16 specifies the cost of an item includes, among other things "any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management." Paragraph 20 of IAS 16 provides guidance on when capitalization ceases and paragraph 55 of IAS 16 provides guidance on when depreciation commences.

The Group discussed what is meant by the phrase "to be capable of operating in the manner intended by management" in the context of ceasing capitalization and commencement of depreciation?

Three views were presented:

- View A – Management may use a pre-determined operating level as a criterion to establish when to cease capitalizing costs.
- View B – Capitalization of costs ceases when the asset can create the output that it was designed to produce on a regular basis even if this is not necessarily at the levels originally planned by management.
- View C – A policy choice is available.

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[1] The title of the Appendix A was revised on 20 January 2015 from that used when this paper was first posted.

[2] The Group consists of members with a range of backgrounds and experience, including preparers, users and auditors of financial statements prepared in accordance with IFRSs. The views expressed by these individuals do not necessarily represent the views of the organization to which a member belongs or the views of the AcSB. The discussions of the Group do not constitute official pronouncements or authoritative guidance.

[3] http://www.frascanada.ca/international-financial-reporting-standards/ifrs-discussion-group/december-9,-2014/item80914.mp3

View A is based on guidance in paragraph 20 of IAS 16 that requires costs be capitalized until the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management. This would suggest management is required to set out its expectations for how the asset will be operated (for example, when operating at a certain capacity threshold).

View B is based on the notion that IFRSs do not contain explicit guidance on how to determine when an asset is capable of being operated in the manner intended by management. Thus, it could be considered that management's intentions with respect to capacity levels are not relevant to the determination of whether an asset is "capable of operating in the manner intended by management". The judgment could then be on whether the asset is in the location and condition to function properly.

View C could be an option if it is considered that IFRSs do not contain explicit guidance on how to interpret the phrase.

During the discussion, there was conceptual support for View B because the approach in View A is subjective and involves a considerable amount of judgment. A point was raised about the difficulty in achieving consistency and comparability among entities if management applies the approach in View A, (i.e., uses a pre-determined operating level) as a criterion to establish when to cease capitalizing costs. It was noted that complete support for View B would be difficult without giving consideration to some measure to assist in applying judgment as to when testing is complete and when the production stage has been entered. A few members also noted that consideration should be given to whether certain components of the asset are already in the location and condition necessary for it to be capable of operating in the manner intended by management.

The Group noted that this is a significant issue across various industries (for example, mining, oil and gas) and thinks that there is diversity in practice. The Group thinks that adding clarifying guidance around when the asset is available for use (i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management) in the context of the full requirement would be beneficial to achieve consistent application.